

# Chapter 1

## Introduction

Over the past decade, U.S. trade deficits have grown steadily from \$29.5 billion in 1991 to a forecasted \$450 billion in 2000. The current figure is the largest trade deficit in U.S. history in absolute terms, and it is also the largest trade deficit measured as a share of U.S. gross domestic product. As each monthly report of the latest trade statistics is released, the print media and the broadcast news carry commentaries and debates over the causes of the deficit and its consequences.

Some take the position that trade deficits are the result of U.S. prosperity and that the inflow of foreign capital and goods have kept inflation and interest rates low and boosted productive investments: they are essential components of American prosperity. Others see a more troubling side to the deficits. They see the deficits as evidence that globalization and the workings of the world trading system pose threats to continued U.S. prosperity.

Congress passed legislation that created the U.S. Trade Deficit Review Commission in 1998 to study "the nature, causes, and consequences of the United States merchandise trade and current account deficits."<sup>1</sup> Congress found that

*The United States is once again at a critical juncture in trade policy development. The nature of the United States trade deficit and its causes and consequences must be analyzed and documented.*

This report presents our conclusions on these issues and our recommendations for action.

## What are the trade and current account deficits?

A trade deficit means that U.S. businesses and consumers buy more goods and services from producers in foreign nations than foreigners buy from U.S. producers during a given period, such as a year. The current account is a broader measure of international transactions. It reflects not only trade in goods and services, but also net factor payments (that is, interest, rents, dividends, royalties, and profits) and transfers (such as pensions, charitable contributions, and foreign aid). As with the trade deficit, if exports of all goods and services plus all receipts of factor payments and transfers are less than imports of all goods and services plus the payments of all payments and transfers, there is a current account deficit. The text box with table 1.1 summarizes the various components of the trade and current account.

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<sup>1</sup> Trade Deficit Review Commission Act, 19 U.S.C. 2213, as amended.

Just as goods and services flow around the world, capital also moves between countries. Bonds and shares in publicly traded companies are bought and sold, loans are made and repaid, and businesses in one country invest directly in other countries when they build factories and distribution facilities. Just as the flows of goods and services go into and out of a country at the same time, the flow of capital is a two-way street. And, just as the flows of goods and services into and out of a country do not often balance, neither do the flows of capital into and out of a country. Trade flows and capital flows, however, are simultaneous. A current account deficit will always have an equal and offsetting surplus on the capital account, and a current account surplus will always have an equal and offsetting net outflow of capital.

### Trade and current account measures

The Bureau of Economic Analysis' U.S. international transactions data provide several measures of trade balances. A balance on goods, often called the merchandise trade balance, measures the difference between U.S. exports and imports of goods, including raw materials, intermediate goods (used in further processing), or goods for final consumption. Similarly, a balance on services measures the differences between U.S. exports and imports of services, including travel, royalties and license fees, and financial services, and business, professional, and technical services. The sum of these two is the balance on goods and services. The balance on income measures the difference between income payments (e.g., interest payments and dividends). The sum of the balance on goods and services, the balance on income, and unilateral current transfers (e.g., U.S. government grants to foreign recipients or private transfers of funds to foreign recipients) is the balance on current account:

**Table 1.1 U.S. International Transactions, 1999**

<b>Composition of the 1999 U.S. Current Account</b>	<b>Billions of Dollars (Rounded to the Nearest Billion)</b>	<b>Percent of Total (Rounded to the Nearest Percent)</b>
<b>International Receipts</b>		
Exports of Goods	684	56
Exports of Services	272	22
Income Receipts	276	22
Income Received from U.S. Direct Investment Abroad (included in income receipts)	119	10
Total Receipts	1,232	100
<b>International Payments</b>		
Imports of Goods	1,030	68
Imports of Services	191	13
Income Payments	295	17
Income Payments from Foreign Direct Investment in the United States (included in income payments)	56	4
Unilateral Transfers	48	3
Total Payments	1,516	100
<b>Balance on Goods</b>	- 346	
<b>Balance on Services</b>	81	
<b>Balance on Goods &amp; Services</b>	- 265	
<b>Balance on Income</b>	- 18	
<b>Unilateral Transfers</b>	- 48	
<b>Balance on Current Account</b>	- 332	

Source: U.S. Dept. of Commerce, *Survey of Current Business*, July 2000

## **An overview of world goods and services trade<sup>2</sup>**

World exports of goods and services in 1998 totaled \$6.7 trillion. This represents a virtual doubling of international trade over the preceding decade.<sup>3</sup> Similarly, U.S. exports roughly doubled during the same period.

Growth in the exchange of both goods and services has consistently exceeded the growth of world production in recent decades.<sup>4</sup> In dollar values, both trade in manufactured goods and commercial services trade grew at a 7 percent annual rate over the period 1990-98. This rate of growth was more than three times the 2 percent annual gain in world goods production over the same time period. While still more rapid than economic growth rates, trade in agricultural goods and mining products rose at the slower annual rates of 4 and 5 percent, respectively, over the same period.

Several other features of world trade are noteworthy:

- The bulk of international trade involves only a few countries. The top ten countries accounted for 59 percent each of 1998 goods exports and imports.
- Asia's share of world goods exports increased from 21.8 percent in 1990 to 24.5 percent in 1998, notwithstanding a decline in Japan's share from 8.5 to 7.4 percent. China's share of world exports rose from 1.8 percent to 3.5 percent over that period. The Asian share of world imports declined over the same period from 20.3 percent to 19.9 percent, with Japan's share declining from 6.8 percent to 5.1 percent. The Asian financial crisis that began in 1997 led to a fall in imports by East Asian countries.
- World services trade is also dominated by relatively few countries. The top ten services trading countries made 61 percent of 1998 world services exports and 58 percent of services imports. The United States is the world's largest exporter and importer of commercial services.
- International trade is important to the overall economic performance of most nations. The United States has witnessed an increase in both imports and exports as a percent of GDP (as can be seen in Figure 1.1), while Canada and Mexico have seen larger increases in import and export shares. Japan's 1998 exports were 11.5 percent of GDP, only slightly above the 11.0 percent for the United States. Japan's imports in 1998, however, were only 9.0 percent of GDP. If intra-European Union (EU) trade is counted as domestic trade rather than international trade, EU member countries' trade-to-GDP ratios drop to a range close to the U.S. ratio. Rising trade-to-GDP portions often accompany fast economic growth in developing nations. China's exports-to-GDP ratio reached 21.5 percent in 1998, for instance, up from 16.8 percent in 1992.

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<sup>2</sup> A more complete discussion of this material is contained in appendix IV and in the research paper prepared for the U.S. Trade Deficit Review Commission by Allen J. Lenz, "The U.S. Current Account: A Sectoral Assessment of Performance and Prospects," which is on the CD-ROM included with this report and can also be found on the Commission's web site [www.ustr.gov](http://www.ustr.gov).

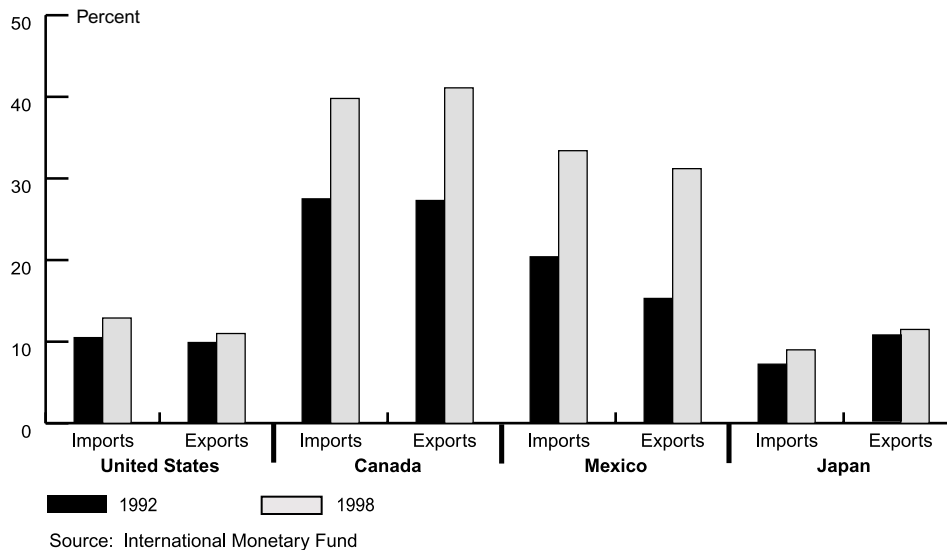
<sup>3</sup> World Trade Organization, 1999 Annual Report (Geneva, Switzerland: World Trade Organization).

<sup>4</sup> Trade data are reported in gross value rather than value-added terms, so the total trade data include some double counting. For example, an auto manufacturer's export of a car would be valued based on the value of the entire car. If the manufacturer imported the engine, transmission, or other components, this would not affect the value assigned to the exported car, even though the imported components would mean that the value added by the assembly of the car—the actual economic activity—was substantially less than the full value.

**Figure 1.1**

**Importance of Trade**

(Imports and Exports as a Percent of GDP)



## Globalization

Overshadowing discussions of trade deficits is the broader trend of globalization. Globalization is an ongoing process that more closely integrates the many national markets for goods, services, capital, and information. It is an ongoing process that has been accelerating in recent years. The recent faster pace has been made possible by the reductions in government barriers to trade and investment and technological innovations in transportation and communication that substantially diminish the relevance of distance for economic transactions. Advances in communication and computing, coupled with dramatic price declines, have made "connectivity" more important than proximity in the sharing of information. Advances in shipping and transportation have made it possible for businesses to deliver a product almost anywhere in the world overnight and for people to travel long distances at much lower cost. While globalization has not made national boundaries irrelevant to commerce, these boundaries are not as important as they were twenty or thirty years ago in determining the location and organization of production.

Globalization has broad implications for people, businesses, and governments. People have greater access to a wider array of goods and services, many of them at much lower prices than were available even a decade or two ago. Perhaps even more important, people can have easier access to information; closed societies cannot easily provide access only to information on the Internet that may promote economic growth while walling off information that may promote political reform. However, globalization also means that Americans will face increased challenges and opportunities in the marketplace and in the workplace. Globalization is breaking

down the barriers between different markets, and that means that virtually anything that can be traded can be produced in the most efficient locations for sale in any market.

Workers have to improve their skills to take advantage of the opportunities presented by globalization. For businesses, globalization creates opportunities to seek lower costs or higher quality in their production. That can mean "outsourcing" more production to suppliers (who can share information), increasing reliance on production in offshore facilities, and making greater use of technological innovations in production. Globalization also means that companies, as well as workers, are more exposed to competition from foreign as well as from domestic businesses and more affected by flows of information from all sources.

Governments are also challenged by globalization. With increased international integration of capital markets and goods markets, the U.S. economy is ever more closely linked with other economies, including some whose political systems, business practices, and values and culture differ substantially from ours. One challenge to the U.S. government is seeking to establish common "rules of engagement," helping to make sure that they are understood by all, and enforcing them.

While globalization has changed the role of national governments and the importance of national boundaries in business decisions, "rumors of the demise of national borders as a factor in world trade are greatly exaggerated."<sup>5</sup> Obstacles to international trade and capital flows have been substantially reduced, but not eliminated. Government-imposed trade barriers are the most evident, but not the only, remaining barriers. International transactions involve exchange rate risk, which is not a factor in domestic transactions. Differences among national tax systems can influence business decisions on the location of production facilities. Investors have not diversified their portfolios across countries as widely as prevailing financial models predict they would if national borders were irrelevant.<sup>6</sup>

## **Trade and current account deficits: historical perspective**

As can be seen in figures 1.2 and 1.3, the United States has run persistent trade and current account deficits for the past twenty years, although this has not always been the case. Further, as figure 1.3 demonstrates, the share of the trade and current account deficits in our GDP has increased since the middle of the 1990s and is forecasted to set a new record in 2000. The data for 1991 appear to show a current account balance; however, the data for that year require a clarification. The international accounts for 1991 include the receipt of payments from allies to reimburse the United States for the cost of the Gulf War. Those payments totaled \$42.5 billion. If these unique payments were removed from the current account data, other things being equal, the deficit in 1991 would have been \$38.2 billion, or 0.65 percent of GDP.

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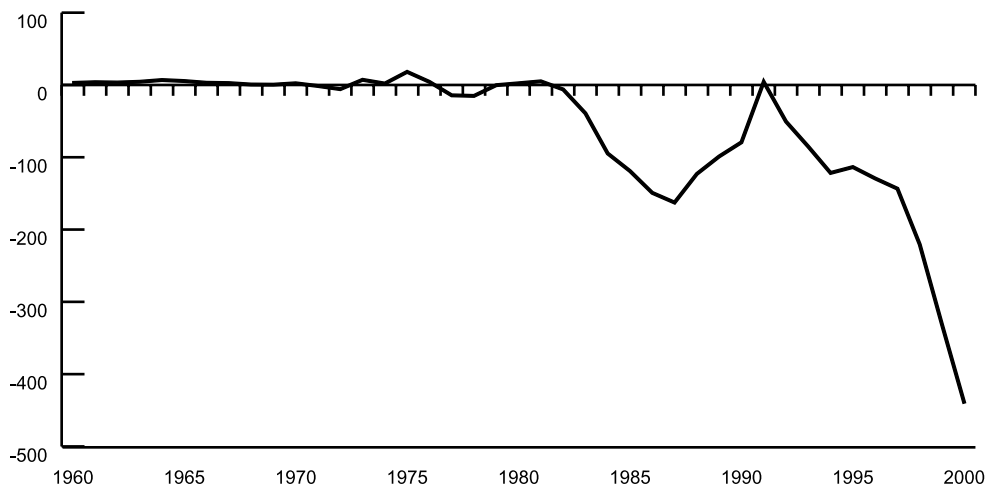
<sup>5</sup> Maurice Obstfeld and Kenneth Rogoff, "Perspectives on OECD Economic Integration: Implications for U.S. Current Account Adjustment," presented at the Federal Reserve Bank of Kansas City symposium on "Global Opportunities and Challenges" (Jackson Hole, Wyoming: August 24-26, 2000), p.4.

<sup>6</sup> As Obstad and Rogoff note, U.S. residents held less than 12 percent of total equity holdings in foreign stocks at the end of 1999, while the models suggest that "optimal" holdings would be closer to the foreign share of world production—closer to 75 percent.

**Figure 1.2**

**U.S. Current Account Balance, 1960–2000**

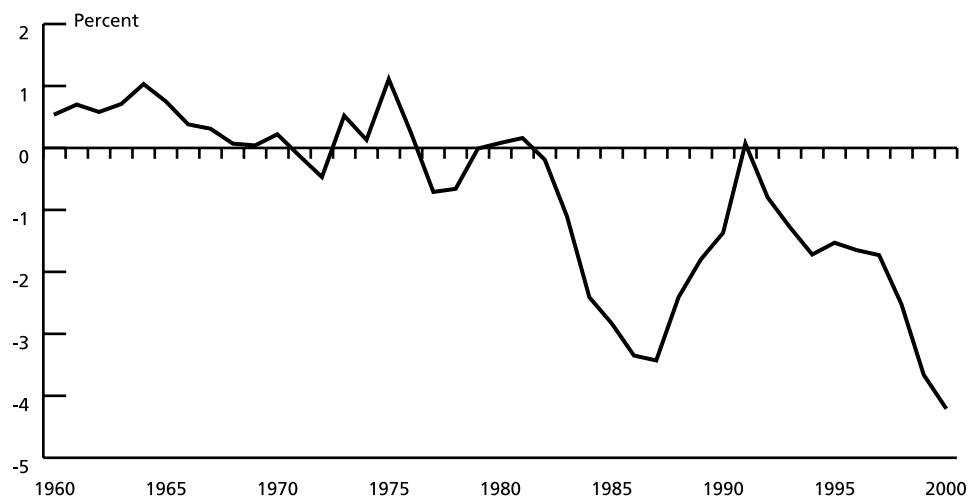
(Dollars in billions)



Source: Historical data from 1999 Economic Report of the President. Data for 2000 based on estimates

**Figure 1.3**

**U.S. Current Account Balance as a Share of GDP, 1960–2000**



Source: Historical data from 1999 Economic Report of the President. Forecasts for 2000 from Merrill Lynch Global Economic Trends, September 2000

## Importance of international trade

Inevitably, questions about the trade and current account deficits intersect with broader questions about international trade and globalization and the process of increased global integration of national markets for products, labor, capital, and technology. These are not simple questions.

Since at least the writings of Adam Smith in 1776, economists have consistently recognized that engaging in international trade enhances a nation's standard of living. Not only does trade provide access to goods and services that would not otherwise be available, it also provides access to goods and services at lower costs than would otherwise be possible. Further, access to international markets provides opportunities for increased business sales and employment. Finally, nations that are open to international trade have far stronger records of economic growth than economies that close themselves off from trade.<sup>7</sup>

According to some public opinion polls, most Americans generally think international trade does generate these benefits but worry that there are costs associated with the benefits. In particular, there is a widespread view that "international trade costs American jobs," that foreign workers making products imported into the United States displace U.S. workers. The political debate of "free versus fair" trade overlays this concern, leading some to believe that the United States does not gain from trade as much as other nations do, particularly nations that "don't play by the same rules."

A recent survey of public opinion captures these ambivalent views:

*Overall, Americans see globalization as somewhat more positive than negative and appear to be growing more positive about it. A large majority favors moving with the process of globalization and only a small minority favors resisting it...*

*In principle, a majority of Americans supports the growth of international trade, especially when the removal of trade barriers is clearly reciprocal. However, Americans are lukewarm about the actual net benefits of trade to most sectors of society, except for the business community. A majority believes trade widens the gap between rich and poor. A strong majority feels trade has not grown in a way that adequately incorporates concerns for American workers, international labor standards and the environment...*<sup>8</sup>

This ambivalence of public opinion toward globalization underlies much of the controversy over the trade and current account deficits and thus deserves attention in this report.

In principle, flows of goods and services between countries are, in some important respects, little different from the flows of goods and services between states of the United States. Consumers are not limited to those goods that can be produced locally, and businesses have opportunities created by larger markets. However, while the U.S. trade and current account deficits receive much attention, no one seems to care whether California or any other state has a surplus or deficit in its trade with the rest of the United States. Why is there this disparity of interest? And why should the U.S. trade deficit be a focus of attention?

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<sup>7</sup> Jeffrey Sachs and Andrew Warner recently found that developed economies that are open to trade grew at an average annual rate of 2.3 percent between 1970 and 1989, while those that were closed grew at 0.7 percent a year. For developing nations, the difference was even greater, with nations open to trade growing at 4.5 percent, and those closed to trade growing at only a 0.7 percent rate. See J. Sachs and A. Warner, "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity* 95:1, (Washington, D.C.: The Brookings Institution), p.36.

<sup>8</sup> Program on International Policy Attitudes, School of Public Policy, University of Maryland: *Americans on Globalization (2000)* (College Park, MD: University of Maryland, 2000).

## **Reason One**

One reason for the focus on the U. S. international trade deficit, but not on the individual states' trade patterns, is a key difference between economic activity within the United States versus trade with other countries. Not only do goods and services move freely around the United States, but workers, capital, and businesses are also free to move anywhere they choose within the country in response to economic opportunity or personal preference. Investors, similarly, can invest their capital anywhere within the country as they search for the highest possible returns.

While relocation may be disruptive and costly, the businesses and workers who move find that the language, laws, business practices, and customs at their destinations are basically the same as in the places that they left. Thus, over the past two hundred plus years of U.S. history, there have been large internal migrations as Americans have moved to states with better economic prospects. The folklore of the country is rich with the stories of the opening of the western frontier, the California Gold Rush, and the exodus from the dust bowl to California. The ability and willingness to move around the country freely in response to changing economic opportunities is one reason for our economic strength over the past century and why the internal trade surpluses or deficits of the various states of the United States are not important.

## **Reason Two**

The federal system of the United States has a single federal tax and expenditure system with built-in mechanisms for fiscal transfers that ease the burden of trade imbalances between states. When there are international trade imbalances, businesses and labor do not move freely in response to the opportunities that arise in other countries. While exports create sales and job opportunities in the United States, workers and businesses may see imports as "taking jobs away" from the United States. If imports are significantly larger than exports, there is an understandable focus on the jobs lost in the import competing sectors – even if national employment is rising substantially.

## **Reason Three**

A third difference stems from the economic and political integration of the United States. There is a common means of payment for goods and services within the United States: a common currency and payments mechanism ensures that transactions across state boundaries are no riskier than those within state boundaries. Further, while there are differences among the states in their legal and tax systems, the Uniform Commercial Code and other shared aspects of the state legal systems, together with federal law, provide some fundamental consistency. If a business is alleged to be violating the law, or if a business believes that it is the victim of another's transgression, each party has the right to its day in court. Workers, similarly, enjoy substantial legal protections. Actions against illegal or "unfair" trade practices across national borders are

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inherently more complex. Worker protections vary from nation to nation. More importantly, actions against a country that violates international trade rules still involve a large diplomatic component. While the World Trade Organization is developing a stronger dispute resolution procedure to deal with trade disputes between nations, it is not authorized to adjudicate commercial disputes between private parties.

#### **Reason Four**

A fourth reason for the attention paid to the current account deficit stems from persistent current account deficits requiring constant "borrowing" from other countries. A decade ago, the value of all foreign assets owned by Americans exceeded the value of all U.S. assets held by foreigners by \$500 billion because we had earlier accumulated assets. As of the end of 1998, the value of all U.S. assets held by foreigners exceeded the value of all foreign assets held by Americans by more than \$1.5 trillion.<sup>9</sup> By the end of 2000, this number could approach \$2 trillion. This \$2 trillion is referred to as the "negative net international investment" position of the United States. Every year that the United States has a current account deficit, the negative net international investment position will grow. And every year, the United States will have to pay profits, interest, rents, and dividends on a growing scale to foreign owners of these assets. Some are concerned that these growing payments may limit the future U.S. standard of living. Furthermore, some are concerned that foreigners may not be willing to continue to provide capital to the United States to finance future trade deficits or, in the extreme, that they may not be willing to keep their current investments in the United States.

#### **Reason Five**

A fifth reason attention is focused on the trade and current account deficits is that they coincide with significant economic changes in the United States. New technology; the end of government regulation of broad swaths of the U.S. economy; and increased exports, imports, and foreign direct investment have produced a more competitive and more efficient U.S. economy. On the plus side, the United States has been experiencing the longest economic expansion in its history, inflation is low and stable, and unemployment is at a thirty-year low. On the down side, there is a rising sense of insecurity among many U.S. workers, despite the very low rate of unemployment. For example, despite the 4 percent unemployment rate, the percentage of workers who fear they will lose their jobs is three times higher today than at the height of the 1981 recession, when the unemployment rate was above 10 percent.<sup>10</sup> Further, despite strong economic growth overall and strongly rising wages for college-educated workers, wages for workers with a high school education or less have been stagnant for most of the last two decades -- although the most recent statistics indicate there has been real growth in these wages in the later half of the 1990s. Globalization and trade deficits have been blamed for the wage stagnation (along with other factors, including technological change). Chapter 3 discusses this issue.

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<sup>9</sup> *Survey of Current Business*, July 1999; direct investment positions are valued at market value.

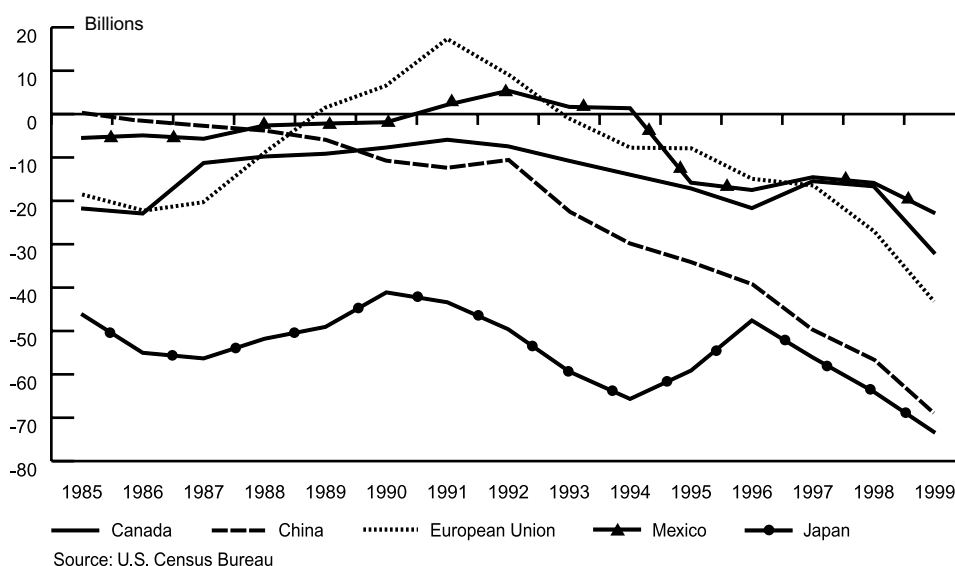
<sup>10</sup> Lawrence Mishel, Jared Bernstein, and John Schmitt, *State of Working America, 2000-2001* (Cornell University Press, Ithaca, N.Y.; Forthcoming, January 2001), p.24.

## Reason Six

A sixth reason for the attention paid to the trade deficit is the persistence of large, bilateral deficits in U.S. trade with certain countries. Bilateral trade deficits are both contentious and potentially misleading. Particular contention surrounds trade with Japan and China because their persistent overall surpluses on trade with the world<sup>11</sup> appear, to some, to be tied to the many obstacles to exporting to these countries and doing business in them. (Figure 1.4 presents the balance of U.S. trade with these countries, as well as the U.S. trade balance with our other major trading partners.) However, bilateral deficits are not as closely associated with the overall deficit as they might appear (see Chapter 2). Whether trade barriers affect the overall trade deficit depends on the interactions of a host of economic variables. Further, foreign export barriers do not affect U.S. decisions to import from a particular country, and U.S. consumers and businesses continue to import from many nations, including China and Japan.

**Figure 1.4**

**U.S. Trade Balances With Canada, China, the EU, Mexico, and Japan, 1985-99**



## Reason Seven

A final reason to care about the U.S. trade deficit is its political effect. As this Commission's legislative charter indicates, trade deficits can lead to political concerns that the current world trading system cannot adequately address the causes or consequences of the deficits. In particular, new efforts to push forward with comprehensive negotiations for further trade liberalization could be put at risk by concerns over the trade deficits.

<sup>11</sup> A deficit in our trade accounts will show up as a surplus in our trading partner's accounts.

## How do trade and current account deficits relate to other measures of economic performance?

As previously noted, a trade deficit results from a nation's total imports of goods and services exceeding its total exports. A current account deficit is a broader measure of international transactions, including a number of other international payments and receipts. An alternative way to look at these deficits provides a starting point for understanding their causes. The trade deficit is also the difference between total domestic purchases of goods and services and total domestic production of goods and services. As the text box on page 2 (Trade and current account measures) indicates, one fixed relationship that emerges from examining the data on the national economy is that a trade or current account deficit (net imports) will also equal the excess of investment over total domestic saving.<sup>12</sup>

Most observers and analysts view the current situation as a demonstration of international investor preferences for investing in the United States, noting the safety and high rates of return on investments here. In that interpretation, capital flows determine what the trade and current account deficits will be. Other observers consider the export and import of goods and services to be the "driver," with the capital account changing to "accommodate" trade and current account deficits. In fact, however, capital flows and trade flows interact and do so in complex and changing ways. At times, trade flows may drive the outcome, with capital flows adjusting or accommodating. At other times, capital flows may dominate and are the primary determinant of current account balances. Waving a magic wand over U.S. consumers and producing an increase in national saving of \$400 billion would not simply eliminate the trade deficit.

## What determines what and how much gets traded?

What gets traded and how much gets traded are two very different questions.

What gets traded depends on the relative competitiveness of a country's industries. Well-developed economic theories identify the factors that determine which industries are competitive in any country. Such factors include the nation's capital stock, the size and skill level of the labor force, natural resources, and technology. These theories provide a starting point to understand what products a nation imports and exports. However, the complexity of trading patterns is indicated by the fact that much of what is exported and imported by the United States and other developed countries consists of the same types of products. The United States both imports and exports automobiles, chemicals, computers, and agricultural products.

How much gets traded and U.S. trade balances are largely determined by the exchange rate of the dollar and the level of economic activity here and in other countries. Changes in the exchange rate of the dollar affect the relative prices of the products of the United States and

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<sup>12</sup> Conceptually, the two are equal. In practice, statistical discrepancies occur.

other countries. Those price changes, in turn, affect what and how much gets traded. If the dollar strengthens, U.S. products become relatively more expensive, and foreign products become relatively cheaper. When this situation occurs, U.S. exports fall and imports rise, everything else being equal. Cases of large deficits in the United States, both in the 1980s and today, occurred during the time of a relatively strong position of the dollar against its major trading partners.

Changes in the levels of economic activity, generally measured by GDP, here and abroad are a second important determinant of how much gets traded. When income in a country rises, consumption in general, including imports, also rises. The faster a country's economy grows, the faster will be the increase in its imports (although not necessarily at the same rate).

## **The seeming paradox of a strong dollar and a large trade deficit**

The relationship between the value of the dollar and the international trade and current account deficits sometimes produces results that may seem paradoxical. The United States will have a current account deficit of about \$450 billion this year. But despite this record deficit and a decade of large and growing deficits, the dollar remains at a very high value in foreign exchange markets. Why is there this seeming contradiction between a large trade deficit and a strong dollar?

The answer is that the value of the dollar is determined by the demand for and supply of dollars in international currency markets. The dollar is bought and sold in markets not fundamentally different from commodities (such as corn, cotton, and gold) and common stock. And, just as commodity and share prices rise and fall in response to changes in demand and supply, the value of the dollar on foreign exchange markets rises and falls in response to changes in the demand for and supply of dollars.

In a world of flexible exchange rates, trade balances and the value of the dollar interact with each other. If trade balances were the only force acting on the value of the dollar, changes in the value of the dollar would tend to bring imports and exports into balance. Demand for exports from the United States creates a demand for dollars by foreigners because dollars are needed to pay for the U.S. exports. When Americans buy imports, they create a supply of dollars. A U.S. trade deficit generally means that the supply of dollars to pay for imports is larger than the demand for dollars to purchase U.S. exports, and the price of the dollar will tend to fall. The lower value of the dollar reduces the price of U.S. exports on world markets (when priced in foreign currencies) and raises the price of U.S. imports (priced in U.S. dollars). Higher prices for imports lead to a decline in U.S. imports, and lower prices for exports lead to a rise in U.S. exports. Hence, the exchange rate of the dollar will fall in response to a trade deficit, and, in turn, the trade deficit will decline in response to the fall in the dollar's value. This is only part of the story, however.

Over the past couple of decades, there has been a fundamental shift in the economic relationships among countries that has altered the link between the trade flows and the value of currencies. That change has been the dramatic rise in international capital flows. Government controls that limited the flow of capital between countries have been substantially eliminated, and modern communications technology has permitted the integration of world capital markets. Investors now invest around the globe, not just in their own countries. In the past quarter century, there has been a dramatic rise in international capital flows.

From the U.S. perspective, the most important consequence of this change is that the demand for and supply of dollars in foreign exchange markets now include both the demand for and supply of dollars that result from international trade and the demand for and the supply of dollars that result from the large flows of capital into and out of the United States. As a result, the value of the dollar is no longer necessarily linked primarily to trade flows and the trade balance at any given point in time. If demand for dollars that results from a large net investment flow to the United States offsets the supply of dollars caused by a large trade deficit, there will not be market pressure to push down the value of the dollar. Consequently, a large trade deficit can coexist with a high value for the dollar.

At any point in time, the value of the dollar is influenced both by what is happening on the current account and by what is happening on the capital account. Of course, changes in the demand and supply for capital will also lead to changes in interest rates, and vice versa. Consequently, both interest rates and exchange rates will change, and both of these factors will have an impact on imports and exports and the level of economic activity.

If the trade or current accounts are "leading the way," and capital accounts are adjusting, then sustained current account deficits should lead to a lower value of the dollar. If, on the other hand, the capital account is the driving force, then rising foreign demand for dollars to finance investments in the United States makes the dollar stronger. In any event, there is always a complex interaction between the two factors. Hence, the seeming paradox of a strong dollar and a large trade deficit is not a contradiction.

Finally, while it would seem that there should be a close linkage between changes in the relative prices of imports and exports, this is not the case. Prices of consumer goods change relatively slowly in response to changes in exchange rates for a couple of reasons. First, exports are typically priced to the market in which they are sold. Consequently, exporters absorb some of the cost of an exchange rate change. Second, the retail cost of an imported product typically includes a significant portion of local currency costs, such as transportation, advertising, and retail expenses. Producer prices react somewhat more rapidly; some estimates imply that, over the course of a year, producer prices will reflect about 50 percent of the exchange rate changes.<sup>13</sup>

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<sup>13</sup> Maurice Obstfeld and Kenneth Rogoff, "The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?" National Bureau of Economic Research Working Paper W7777, (Cambridge, MA: NBER, July 2000).

## The work of the Commission

The Commission, in carrying out the mandate specified in the statute that created it, undertook the following activities:

- We held ten public hearings and technical briefings throughout the United States to collect broadly based information and analyses from leading scholars and experts; representatives of industry, labor, agricultural, environmental, and human rights organizations and other interest groups; and officials of the federal, state, and local governments.
- We commissioned research papers from scholars on a number of issues about which the Commission believed it needed more detailed information and analyses.
- We held meetings at which Commissioners deliberated on the meaning and significance of the data and analyses they reviewed and at which they developed the recommendations that the Commission is making in this report.

## Structure of the report

This report examines at length the issues in the Commission's mandate to assess the causes, consequences, and remedies for the trade and current account deficits:

- Chapter 2 examines the causes of the trade and current account deficits.
- Chapter 3 reviews the consequences of the trade and current account deficits, including the costs, benefits, and other impacts of the trade and current account deficits.
- Chapter 4 assesses the sustainability of the large trade and current account deficits.
- Chapter 5 analyzes current and proposed policies to provide adjustment assistance to those impacted by trade and other labor market disruptions.
- Chapter 6 addresses the role of trade policy and recommends changes in trade policy and programs, and the organization of trade responsibilities in the federal government.
- Chapter 7 deals with the statistics used to report on U.S. international trade and the current account and presents recommendations for improving these data.

As the Commissioners studied these matters, they developed a consensus on some issues but not on others. Where there was a consensus, unified chapters are included in the report presenting the views of the Commission as a whole (Chapters 1, 5, and 7). Where a consensus was not reached, two different presentations are contained in the pertinent chapter. Thus, Chapters 2, 3, 4, and 6 appear as double chapters reflecting the different views of the Republican and Democratic Commissioners, respectively.

Furthermore, any consensus (whether reflecting the entire Commission or only the Democratic- or Republican-appointed Commissioners) represents a general agreement among the Commissioners involved. It does not mean that each individual Commissioner agrees with the precise way in which a specific issue is presented. It is inherent in the nature of a group effort that individual members may hold personal views on a specific issue that he or she might express somewhat differently in an individual statement.

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Note: This report does not specifically address the effect, if any, of "offsets" on trade and current account deficits. Offsets are provisions often associated with exports of military equipment that require an exporter to meet certain conditions in return for the export sale. For example, the exporter may agree to purchase some other product made in the importing nation. After our Commission had begun its work, Public Law 106-113 created a separate National Commission on the Use of Offsets in Defense Trade that was charged with examining this issue in depth.

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This report includes a CD-ROM containing the record of the Commission's public hearings and the research papers prepared for the Commission. Publication of the hearing record and research papers is intended to promote greater public understanding of the issues addressed in this report and does not necessarily imply an endorsement by the Commission or any individual Commissioner of views expressed in the hearing record or research papers.

